A PLAN FOR A MODIFIED CENTRAL BANK

THE appalling panic which we have experienced during the last few weeks will do more, I suppose, to bring home to the public the absolute necessity of a change in our present banking and currency system than all the efforts that have hitherto been made to warn the nation of the imminent danger. It is to be expected that Congress will take some action on this question at its next session, but it is sincerely to be hoped that it will not follow the line of least resistance by adopting some paltry palliative, but that the question will be approached in a bold and broad spirit.

As I tried to prove in a previous paper on " Defects and Needs of Our Banking System," which *The New York Times* published in its Financial Supplement in January last, nothing short of a modern central bank will effect a final solution of the problem, but, as was also indicated in that paper, we are still so far removed from the fundamental conditions which would have to be created in order successfully to establish a central bank on the European basis that the attempt to take so far-reaching a step would involve material and harmful delay.

There are grave objections, however, to the scheme, advocated by so many, of creating an emergency currency by permitting each national bank independently to issue unsecured notes up to a certain percentage of its share capital, subject to a tax sufficiently heavy to insure the prompt withdrawal of these notes when times again become normal. If issued individually by each national bank, without a joint guarantee by all the national banks, such notes would add a new element of danger in times of panic.

Let us imagine what would have happened during the last few weeks when one of the national banks became somewhat involved, if notes of this kind had been outstanding. It stands to reason that the panic which caused a run of the depositors

would have been carried into the ranks of the noteholders, and it might easily have intensified the distress by creating a general lack of confidence and wholesale discrimination against national bank notes, thus aggravating the general hysteria and increasing the withdrawal and hoarding of legal-tender currency as well as gold. It is, moreover, not at all improbable that the emergency notes of this bank and those of a majority of the other banks would have been in circulation before the real pinch came, as a great many people thought that the culminating point had been reached when, as a matter of fact, the crisis was only beginning.

Further, it is bad practise to allow a bank to issue unsecured notes, which are to pass as current money, against investments in single-name commercial paper or against loans of all kinds, as, for instance, in this case, on inflated copper and bank stocks. No European central bank would be allowed to proceed in this way. There are strict regulations as to the loans which these note-issuing banks are permitted to make; and as to their purchases of commercial paper additional guarantees (generally three good signatures) are required.

It is very doubtful whether the stronger national banks would consent to a joint guarantee by all the national banks for the entire amount of unsecured notes issued by the national banks. This could be done safely only if they could exercise a material control over their sister banks.

As a way out of the difficulty, the following plan is suggested—a plan which does not purport to cover the situation fully, but embodies a general sketch of what might possibly be tried. The scheme adopts some of the good features of the European system, while it seeks to avoid those parts of the European machinery which could not well be adapted to our present conditions.

It is proposed to create at Washington a bank, to be called hereafter the Government Bank, endowed with a capital of from $50,000,000 to $100,000,000, possibly paid up only in part, the share capital to be owned, if feasible, half by the government and half by the national banks, and the management to be in the hands of a salaried president or presidents, who

are to be appointed for an indefinite period by the board of directors. The board of directors is to consist of delegates of the various clearing houses of the central reserve and reserve cities; the Secretary of the Treasury and the controller of the currency are to be members *ex officio,* and some additional directors are to be appointed by the stockholders, by the Supreme Court, and by the chambers of commerce of, let us say, New York, Boston, Philadelphia, and Chicago.

This is only a rough outline, susceptible of easy modification, intended merely to show how it is possible to create a board which would be independent of politics, which would comprise men of business knowledge and experience, and which, by its composition, would afford a reasonable guarantee that it would not be swayed by selfish motives in its actions.

The Government Bank would receive the treasury's moneys, and the deposits of these moneys with the national banks would in turn be made by this bank. The Government Bank would have the right to issue legal-tender notes, not to exceed a certain multiple of its capital and its holdings of gold or of gold notes. The bank would, in the main, be limited to transactions with the clearing houses of the various cities of the United States and with the clearing-house members.

The Government Bank would be allowed to deposit moneys with the clearing-house institutions and national banks in the country against collateral, taking United States government securities at 90% of their market value, municipal securities at 80% of their market value, and railroad bonds at 60% of their market value. (The percentages above given are again only illustrative of the way in which government moneys, through the medium of the government bank, could safely be put out against good securities on a plan similar to the European mode of handling government moneys.)

The bank would establish a general rate of interest for such deposits, such rate to be modified from time to time, very much as is done under like circumstances by the European government banks.

The bank would be allowed to advance money against

clearing-house certificates of the banks of the central reserve and reserve cities of the United States.

It would further be allowed to buy paper running for a period not to exceed three months, made out in dollars or in sterling, francs, or marks, such paper to be strictly commercial paper and to bear at least three signatures, of which one must be that of a well-known bank, trust company, or banker. The privilege of buying such foreign paper is proposed in order to enable the government bank to accumulate a reserve of long bills having a gold basis, as is done by the European government banks. Such bills would be used to meet and to counteract, as far as possible, demands for gold which might be made upon us from time to time by other countries.

The authority for the government bank to buy three months' dollar paper, also bearing at least three signatures, including a bank's or banker's indorsement or acceptance, is added for the purpose of encouraging the creation of such paper, the lack of which is largely the cause of the immobilization of the resources of our banks.

It would probably suggest itself that a limit be set to notes issued tax-free by the Government Bank, and that a penalty be paid for notes issued in excess of this limit.

The general scheme as roughly outlined above has this advantage, that the control of the clearing houses over the individual banks would be strengthened, while it would, on the contrary, be weakened through the general emergency-currency plan. The clearing house would, as a matter of course, examine the collateral against which a national bank proposed to take out currency from the Government Bank by means of the clearing-house certificate. The clearing house would thus be able, to a certain degree, to prevent the moneys so received from Washington from being used for any but strictly legitimate purposes.

The clearing-house committee would have the right, but not the duty, to issue such certificates, and it could, through this power, hold a check on those institutions which it might regard as not sufficiently conservative. Moreover, the clearing-house committee would pass on the question in general whether

or not it would be well for the community to issue additional currency.

The idea that the issuing of clearing-house certificates in itself implies the existence of a crisis would soon disappear, and before long the general public would be as little excited by it as is the German public when the limit of the amount of notes which may be issued without paying a tax has been reached. The issue of clearing-house certificates would mean, in general, that it is time to go slow, but it would not necessarily imply the imminence of a panic.

The scheme as proposed above would have the further advantage that clearing-house certificates, which now merely allow the banks to draw on their reserves, without increasing the currency, would serve in future as a means of providing additional currency, and while clearing-house certificates now materially increase the difficulty of settling the debits and credits between the various cities, they would, if used in the way proposed above, facilitate the intercourse between the cities. The Government Bank would act as the clearing house for the clearing houses.

It is not beyond the bounds of imagination that local boards for branches of the Government Bank in the various cities could be established, taking the clearing-house committee or some members thereof as a nucleus around which some other independent members might be added. It is also possible that these agencies would receive moneys in one city in order to pay them out in the other, as is done by the Reichsbank of Germany. It is precisely in times of panic, when so much currency is absorbed by unnecessary shipments from one place to another, that it would be a blessing to have a safe mechanism to act as a daily clearing house between the cities.

There are, of course, many sides to this question which need further discussion and elaboration in detail. I have tried, however, to confine myself to the presentation of the rough outlines only of a plan which seeks to avoid all those aspects of a central bank which render it objectionable to many.

In the bank contemplated the composition of its board is a guarantee that we shall not have "politics in business," and

the limitation of its scope of business eliminates all danger of selfish or speculative use of its moneys. At the same time we should be laying a broad foundation on which it may be possible gradually to build a modern financial structure.

This scheme will perhaps meet with opposition from the numerous small country banks which are not members of a clearing house, and which, of course, would prefer that each bank should have the right to issue emergency notes independently for its own account. It is to be hoped that selfish considerations will not prevail in the solution of the problem, which is one of the most serious the country has faced for many years. Moreover, it should not be difficult gradually to work out some device, by means of which each clearing house would be enabled to take care of the banks of the surrounding cities. Above all, even if the scheme embrace for the present only the clearing houses in larger cities, there can be no doubt that it would prevent any recurrence of the present situation, which practically means a temporary suspension of payment all over the country.

We need some centralized power to protect us against others and to protect us from ourselves, some power able to provide for the legitimate needs of the country and able at the same time to apply the brakes when the car is moving too fast. Whatever causes may have precipitated the present crisis, it is certain that they never could have brought about the existing outrageous conditions, which fill us with horror and shame, if we had had a modern banking and currency system.

With our present methods our " elasticity " depends principally on stock-exchange loans, while the most legitimate business, the purchase of commercial paper, causes a dangerous locking up of capital in single-name promissory notes, which under normal conditions cannot be resold.

My previous paper fully explained that this is exactly the opposite of the European and of any modern system and that by modernizing the form of our commercial paper and by creating a central bank we should aim to transform our commercial paper from a non-liquid asset into the quickest asset of our banks. This change, however, is so far-reaching that

it would take years of educational work to carry it out, while relief should come at once.

In creating a central bank with limited powers and in making clearing-house certificates the regular means of rediscounting and of taking out additional currency in times of scarcity of money—not a means to be used only as a last resort in a severe crisis—we should adequately meet the situation. To the single-name paper we should add the guarantee of the joint clearing-house institutions before making it the basis of our current notes, which, with the additional weight of the issuing Government Bank, would form a safe means of elastic circulation, based on the legitimate demands of trade and industry.

Incidentally, we should gradually extend the influence of the clearing houses and the Government Bank, not only over the finances of the whole country in general, but also over individual concerns, against the reckless financial management of which these bodies might feel called upon to discriminate. Instead of giving vast and vaguely defined powers, properly belonging to a central bank, to one or two political officers—possibly without business training—and instead of putting the burden and responsibility on them alone, we should define the power and responsibility clearly and should associate with our political officers in bearing it a large body of our best-trained business men. This would mean a democratic, a conservative, and a modern way of self-government.